

Enhancing multilateral development bank resilience and lending capacity

Crisis management, recovery planning and improving loss-absorbing capacity

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If multilateral development banks (MDBs) are to expand their balance sheet to meet the development challenges of the future, they need to consider what actions to take should they experience financial stress.

MDBs need to put in place arrangements to ensure their critical lending services continue in both normal and stressed markets.

MDBs should enhance their crisis management capabilities by establishing key building blocks and developing recovery plans to enable those MDBs to be recapitalised.

MDBs could enhance their recovery capacity by assessing the feasibility of the new Perpetual Bond Facility proposal. This facility could also support additional lending today.

Shareholders should establish an external expert panel to advise on the credibility of MDB end-state capital structure and its effectiveness in supporting MDB resilience and recovery capacity.

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Acronyms

AfDB	African Development Bank
CAF	capital adequacy framework
CAR	capital adequacy ratio
CC	callable capital
CEF	critical economic function
CRA	credit rating agency
FSB	Financial Stability Board
G20	Group of Twenty
IBRD	International Bank for Reconstruction and Development
IDB	Inter-American Development Bank
MDB	multilateral development bank
PB	perpetual bond
PIF	Proactive Intervention Framework

Executive summary

Understanding multilateral development bank (MDB) financial resilience arrangements and how they could be improved is an essential part of preparing for \$300 billion per year lending growth, as called for by an independent experts group commissioned by the Indian G20 (Group of Twenty) presidency in 2023 (G20 Independent Experts Group, 2023). If MDBs are to expand their balance sheet to meet the development challenges of the future, they need to consider not just how they ensure their maintenance of the AAA rating, but also what actions they might take should they experience financial stress. MDB planning for financial stress is part of best practices in risk management for all financial institutions, both commercial and public.

The need for MDB resilience to financial distress was recognised at the establishment of MDBs in the 1940s with the creation of callable capital (CC) to give confidence to bond markets to lend to MDBs at the time. However, CC is not well understood in the context of today's capital market expectations and lacks the capital adequacy features typical of financial institutions today.

This paper discusses the essential building blocks MDBs need to develop wider crisis management arrangements and loss-absorbing capacity. These are preconditions for greater integration of CC into MDB capital adequacy frameworks. Achieving this will require MDBs and shareholder governments to establish a systematic approach to responding to MDB financial stress. Such reforms will strengthen market confidence in the resilience of MDBs today and support their future growth.

The paper proposes that MDBs should develop a common approach to prepare for and respond to financial stress. As unregulated entities, MDBs are not subject to any consistent set of capital or liquidity standards or expectations; therefore, close coordination between MDBs and MDB shareholders will be essential to ensure a consistent and coherent approach. Unlocking any additional MDB lending capacity related to CC, or other examples of enhanced financial resilience, depends on MDBs implementing a multi-year reform programme to deliver changes that have been mainstream in the commercial banking world since the 2008 global financial crisis. These changes include the following:

- Defining MDB lending as critical financial services – It should be recognised that many MDB's lending services are critical financial

services that cannot be placed into liquidation in the event of failure without catastrophic consequences for shareholder policy priorities, global economic development and international financial architecture. This policy principle requires the development of MDB capacity and plans to identify and recover from financial stress, including non-viability, such as ensuring callable capital is a credible tool for protecting bondholder.

- Enhanced MDB crisis management capabilities – As MDB capital structure begins to evolve to include hybrid instruments and other loss-absorbing capacity options, they need to develop a description of how the MDB crisis continuum might evolve by developing and maintaining in-house stress testing capabilities. This improved description of MDB stress should be accompanied by a new MDB Proactive Intervention Framework (PIF) designed to feed into the identification and response to MDB stress by management. This will be informed by clearly defined methodologies for assessing MDB non-viability, used to inform MDB management action determined by dedicated MDB crisis management governance arrangements.
- Developing MDB recovery plans – This requires MDBs to put in place the necessary financial arrangements and recovery plans to enable MDBs to be recapitalised or benefit from CC, so as to continue their lending services in the event non-viability is likely to be reached. Development of MDB recovery planning capabilities will build on enhanced MDB crisis management capabilities, themselves related to enhanced reverse stress testing capabilities, monitoring frameworks and how to identify the point of non-viability.
- Enhancing the capital structure and lending capacity of MDBs through the development of alternative capital instruments and strategies – MDBs should develop, document and agree with shareholder governments recovery actions that provide sufficient solvency options to recover from extreme solvency stress scenarios, including from the point of non-viability. This should include considering the conditions for paid-in capital injections, issuance of hybrid instruments and other instruments. For example, MDBs could enhance their solvency recovery capacity by assessing the feasibility of the new Perpetual Bond Facility proposal outlined in this paper.
- MDB financial resilience: shareholder Expert Advisory Panel – Developing such additional MDB crisis management capacity requires significant investment by MDB management to establish modelling, reporting and internal monitoring arrangements, as well as designing credible recovery actions that are sufficient to recapitalise MDBs that become non-viable. Ultimately, the effectiveness of these new MDB recovery arrangements will determine the risk to shareholders. The materiality of the recovery actions MDBs develop is an expression of their and their

shareholders' risk appetite. To support shareholders in assessing MDB recovery capacity, an Expert Advisory Panel should be established to advise shareholders as part of MDB regular business planning cycles on the effectiveness of MDB recovery options.

Recommendations table

Table 1 Main recommendations: enhancing MDB recovery capacity			
Recommendation	Priority	Timing	Lead
1. Defining MDB lending as critical financial services and as a result, liquidation is no longer an appropriate outcome for MDBs that reach the point of non-viability.	H	I	MDB management and shareholders
2. Enhanced MDB crisis management capabilities by establishing key building blocks, including standing, in-house reverse stress-testing capabilities, designing a framework for assessing MDB non-viability and a Proactive Intervention Framework to facilitate timely management action in response to increasing stress levels.	H	NT	MDB management
3. MDBs to develop recovery plans to enable MDBs to be recapitalised or benefit from callable capital, so as to continue their lending services in the event of severe financial stress or reaching the point of non-viability.	H	NT	MDB management
4. Shareholder governments appoint an MDB to take the lead in the development of a Perpetual Bond Facility pilot in discussion with shareholders, credit rating agencies (CRAs) and capital market experts as part of efforts to enhance capital resources today and recapitalisation options in an extreme stress.	H	NT	MDB management
5. Shareholders to establish a standing external expert panel to advise on the credibility of MDB end-state capital structure, and its effectiveness in supporting resilience and recovery ability under agreed business plans and lending targets. The panel should be composed of experts with a background in reverse stress testing, capital policy, recovery planning and crisis management.	M	NT	Shareholders , with MDB funding
Timing: I = Immediate (within one year); NT = Near term (1–3 years); MT = Medium term (3–5 years); Priority: H = High; M = Medium; L = Low.			

1 Introduction

Recent years have seen an increase in government, MDB and civil society debate on how the international financial architecture can best meet the significant poverty and climate change challenges facing the world. Multilateral development banks (MDBs) are under pressure to expand their balance sheets. However, how to provide the capital needed to support lending is less clear. Shareholder governments are encouraging MDBs to consider alternative approaches to improve their lending capacity before additional shareholder capital injections are considered.

MDBs have been discussing options for modernising MDB capital structures and enhancing their loss-absorbing capacity to deal with crisis for decades. The 2009 Pittsburgh G20 leaders' communique agreed that shareholder governments would 'Consider how mechanisms such as temporary callable and contingent capital could be used in the future to increase MDB lending at times of crisis' (G20 Leaders Communique, 2009). More recently, since the publication of the G20 Capital Adequacy Framework review (G20 CAF Panel, 2022), there has been a major increase in interest in MDB capital structure and balance sheet optimisation options. Many of these options aim to borrow techniques that have existed in the commercial banking world for many years, or consider how MDB callable capital can be better reflected in MDB capital adequacy frameworks.

MDBs have a unique capital structure composed of paid-in share capital and callable capital, a treaty-based commitment by shareholders with a nominal value of \$880 billion across the eight largest MDBs. However, understanding the true value of callable capital is challenging given its ambiguous nature (Humphrey, 2024). This ambiguity, as well as the creation of new hybrid capital structures and other innovations, raises important policy questions that need to be addressed if such innovations are to achieve the desired uplift in lending capacity.

This paper aims to support MDBs in developing a common approach to prepare for and respond to financial stress. It introduces options for increasing MDB resilience in four further chapters following on from this introduction:

- Chapter 2. Enhancing MDB resilience, recovery plans and lending capacity – How MDBs can and should enhance their resilience to financial stress if they attempt significant balance sheet expansion.

- Chapter 3. New recovery options and impact on lending – This chapter proposes a new option to enhance MDB solvency and recovery capacity, termed the ‘Perpetual Bond Facility’ (‘the Facility’).
- Chapter 4. Supporting MDBs to enhance resilience – The paper introduces the concept of an Expert Advisory Panel to advise shareholders and MDBs on approaches to enhance financial resilience and calibrate risk appetite, which are needed to expand MDB lending capacity.
- Chapter 5. Conclusions – The paper concludes with some suggestions for future action and policy development.

2 Enhancing MDB resilience, recovery plans and lending capacity

2.1 Economic rationale for enhanced MDB resilience

MDBs provide important financing services that are critical to the economic development of many borrowing countries. As a result, MDBs need to have the necessary arrangements in place to ensure those financial services continue in both normal and stressed market conditions, in the same way that commercial banks do (for example, prudential capital and gone-concern loss absorbency requirements). While MDBs may not be subject to the excessive risk-taking problem that motivates some commercial banking regulations, there are other strong policy reasons for MDBs to have resilience arrangements in place like banks.

Commercial banks and MDBs both carry out important public policy functions, where a temporary discontinuity in these lending services could have policy implications including for economic growth, particularly in MDB borrower countries. Commercial banks safeguard our savings as deposit takers and through credit intermediation support economic growth. While MDBs are not deposit funded, they play a critical role in poverty reduction or climate change mitigation, as an essential provider of credit to both public and private sector actors who are not able to access similar credit in the private funding market. In addition, there are often limited or no substitute providers of creditors available to MDB borrowers. Any temporary disruption of MDB lending capacity would not undermine national financial stability or harm retail depositors like a commercial bank failure. However, it could have significant implications for the sustainable economic development of the borrower country and the ability of the international community to achieve vital global development policy goals. In this sense, there is likely to be a strong link in many borrower countries between ensuring continuity in MDB financing services and the stability of the wider economy and the financial system within it.

Resilience requirements – such as ensuring MDB have adequate loss-absorbing capacity – also aim to maintain optimal risk-sharing between shareholder governments and MDBs' management to maximise economic efficiency. Resilience reforms help to align the

motivations of the MDB as an executive with the shareholders' policy purposes or their strategic objectives for MDBs. Improving the ex-ante resilience of MDBs is also consistent with protecting public policy objectives and public funds in times of stress. As echoed in G20 CAF recommendation 1A (G20 CAF Panel, 2022), the level of MDB recovery capacity is ultimately an expression of risk appetite and should be calibrated for both normal and stressed market conditions between MDBs and their shareholders.

MDBs are not profit maximisers or prone to excessive risk-taking in the same way as commercial banks. However, a strong policy rationale remains for MDBs to be subject to enhanced resilience reforms beyond a sole reliance on future shareholder capital injections. Improved financial resilience would enable MDBs to better maintain continuity in the important lending functions they provide through the economic cycle. Rigorous financial resilience arrangements for both normal and stressed economic conditions for MDBs would be beneficial for the operation of MDBs and for governments' fiscal exposure as shareholders. This would improve the way MDBs are perceived by funding markets, further bolstering their ability to access those markets at sustainable prices. Credit rating agencies would also reflect such enhancements in MDB resilience when setting ratings.

2.2 Conceptual building blocks for enhanced MDB financial resilience

MDBs have well-established risk management and capital adequacy frameworks (CAFs) for 'business-as-usual' purposes. They limit credit risk relative to a target capital adequacy ratio (CAR) at the end of a specific period (between three and ten years). Some MDBs conduct stress testing, examining the impact of different borrower default and wholesale funding cost increase scenarios on their internal CAR or ability to sustain planned lending targets. However, most MDBs have limited internal arrangements to regularly monitor proximity to non-viability or default.

MDB risk management frameworks focus on assessing risks to maintain high credit ratings, minimising the cost of funding and responding to shareholders' direction to maintain AAA ratings with credit rating agencies (CRAs). As a result, MDBs have tended not to focus on ensuring they have adequate internal financial capacity to manage during severe economic scenarios while still supporting their core policy purpose. So far, this approach has served them well.

However, if MDBs are to significantly expand their balance sheet to meet the development challenges of the future, they need to consider actions they might be forced to take should they experience financial stress. The need to prepare for such stress scenarios is not an indication of their likelihood. Good internal preparation and funding market understanding of the arrangements MDBs have developed to

respond to financial stress help dampen the effects of that stress and, in many instances, prevent the situation from deteriorating any further. Preparing for a crisis will require MDBs to address questions they have not had to face in practice.

This section introduces key concepts needed for a credible crisis management arrangement, including:

- the need for continuity, not liquidation, at the point of non-viability,
- defining the MDB stress continuum,
- assessing MDB non-viability, and
- a framework for identifying and responding to MDB stress.

MDB failure – continuity of services, not liquidation

One of the primary purposes of financial resilience requirements for any financial institution is to ensure continuity in the important financial services that they provide. This enables the orderly functioning of the financial markets, which is important given the importance of banks (including development banks) to wider economic development and to the borrowers who depend on those services. Financial resilience of financial institutions also helps minimise the risk to taxpayers in the event of a disorderly failure of financial institutions. This is particularly relevant for MDBs, given that their sole shareholders are sovereign governments.

A key lesson from the global financial crisis of 2008 is that insolvency is not a desirable mechanism for managing the orderly failure of a bank. Once a bank enters insolvency, it needs to suspend all operations, resulting in disruption of credit and lending flows in the market to support economic growth and development. The inadequacy of liquidation as a means of managing bank failure forced many governments to use large sums of taxpayers' money to bail out failing banks. Leaders of the G20 countries learnt from the experience and gave bank regulators the ability to ensure that the critical financial services provided by a failing bank continue, including the lending services necessary to support growth of the real economy. This is not just relevant for the largest and most systemically important banks, often described as 'globally systemically important banks' or concerning the term 'too big to fail'. Instead, many regulators now consider liquidation appropriate only for the smallest banks in their financial systems given the importance of maintaining continuity in the services they provide to the economy.

Our research has found some consistent views across MDBs on how they consider financial stress. MDBs would judge the loss of AAA rating as indicative of MDB entry into a period of extreme stress. MDB management assess that MDB statutes imply that, should an

MDB get into financial distress and risk defaulting, it should call on callable capital to repay senior bondholders, and the remainder of the business should enter a liquidation or winding-up process. Instead, MDBs could internalise the lessons learned during the 2008 global financial crisis, which recognise that many banks, including MDBs, provide critical financial services. These are services, including credit provision, on which the real economy and wider economic development depend. As a result, such services should not be placed into a liquidation in the event of failure because this is inconsistent with important economic policy objectives.

The Financial Stability Board (FSB) defines many of the services provided by banks as critical economic functions (CEFs), that is: 'Activities performed for third parties [for example, borrowers] where failure would lead to the disruption of services that are vital for the functioning of the real economy and for financial stability' (Financial Stability Board, 2013). The term 'critical functions' means activities, services (for example, lending) or operations that, if discontinued, would likely lead to disruption of services that are essential to the real economy or would disrupt financial or economic stability.

The recent decision by the Bank of England to rescue the failing UK subsidiary of Silicon Valley Bank highlighted the importance of maintaining 'the continuity of banking services, minimising disruption to the UK technology sector and supporting confidence in the financial system'¹, as the key reason for its intervention and to avoid the bank's entry into liquidation. This is a demonstration that continuity in lending services to specific sectors or borrowers important for wider economic development is a sufficient basis for defining a banking service like lending as a CEF. It also illustrates that, even for small firms, liquidation is not considered appropriate if it undermines the continuity of lending services important to the real economy. Therefore, any financial institution, including MDBs, should take action to ensure continuity in the event of stress from the critical lending services they provide by making the necessary arrangements to avoid liquidation.

The financing services provided by many MDBs should be considered CEFs, as defined by the FSB. Continuity in MDB lending must be maintained to meet development policy objectives and minimise the risk of macroeconomic instability in many borrowing countries. MDBs should no longer consider liquidation as the appropriate paradigm for their business model, given their importance of many of their lending services to shareholder policy objectives and borrowing for country development. Instead, MDBs need to consider what arrangements can be put in place to enable them to be stabilised and recapitalised, thereby maintaining their critical credit service provision, should an MDB approach the point of

¹ Bank of England, Statement on Silicon Valley Bank - <https://www.bankofengland.co.uk/news/2023/march/statement-on-silicon-valley-bank>

non-viability or fail. Any new recovery planning arrangements developed by MDBs need to be sufficient to enable an MDB to avoid entry into a liquidity or winding-up process if such a stress were to materialise. See below for further discussion of MDB recovery planning and options for enhancing MDB financial resilience in such scenarios.

Defining the MDB stress continuum

MDBs need to develop the capacity to respond to increasing levels of financial stress, including recovering from a non-viability event. To do so, MDBs should have a detailed and refined understanding of what stress looks like for their business model. MDBs will need to develop in-house reverse stress-testing capabilities as part of their standing risk management and internal reporting arrangements. This focuses on identifying future scenarios that could lead to their failures and can be developed to leverage their existing stress-testing capabilities. In addition, they should use that modelling to define the progression of events for an MDB from normal operations, to stress, extreme stress and to the point of non-viability.

Given their low-risk business models today, MDBs have had limited experience with stress and have not prioritised the development of an operational understanding of risk management with respect to crisis management. It will be important to describe how stress might emerge and evolve in an MDB balance sheet and codify those management actions that would be most appropriate to take to drive recovery at increasing levels of stress, all the way up to and including a capital call or, ultimately, the point of non-viability. If MDBs want to significantly expand their balance sheets, it is important for them to invest in such crisis management arrangements as leverage increases, to demonstrate to shareholders that operations remain within agreed risk appetite, and to maintain the confidence of wholesale funding markets.

A clear description of an MDB crisis continuum is an important foundational component of MDB crisis management capabilities. If MDBs need to avoid entry into liquidation, they need to have a clear description at all times of where they are on the spectrum between normal operations and non-viability. By illustrating the different stages of the MDB life cycle from good times to crisis, MDBs will be better able to identify: 1) policy trade-offs involved in achieving continuity of MDB lending services, and 2) the points of coordination between MDBs and shareholders as the organisation experiences increasing levels of stress. Greater clarity on the MDB stress continuum helps codify the understanding that MDBs need arrangements that allow them to recover. In a crisis, it also helps identify key decisions required of MDBs and/or shareholders as stress increases to build a shared understanding of how to maintain continuity in critical lending services.

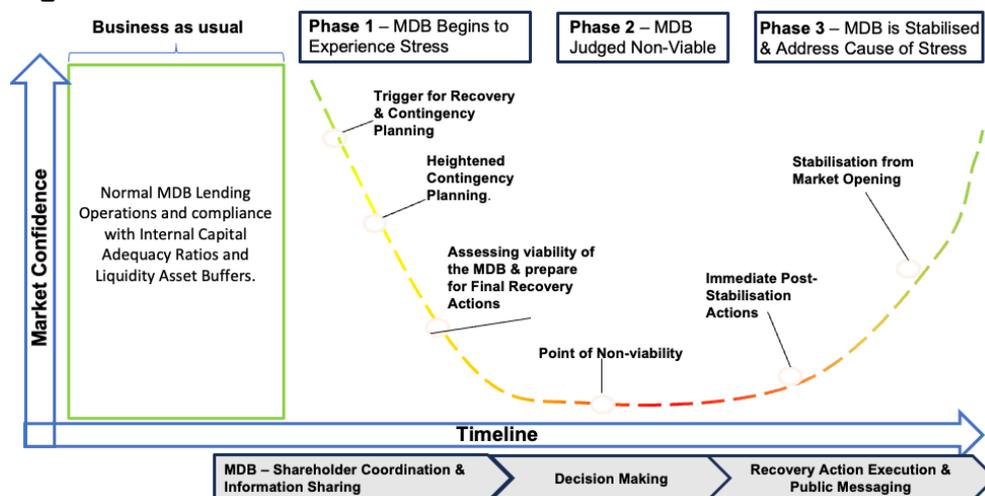
Figure 1 Illustrative MDB stress continuum

Figure 1 provides an illustration of the different phases of an MDB in crisis. In Phase 1, the MDB begins to experience stress but remains a going concern through the implementation of credible management/recovery actions. In many cases, this will allow the MDB to return to ‘business as usual’. There is nothing inevitable about reaching the point of non-viability if MDB management acts to avoid further deterioration at an earlier stage in the stress continuum. However, in some cases, the MDB may proceed to Phase 2 as its recovery actions have failed to stabilise the MDB and it approaches the point of non-viability. Phase 3 describes the impact of an MDB being assessed as non-viable but being stabilised through recapitalisation to avoid entry into liquidation.

An MDB will need clarity on what triggers define each phase, what decisions are required at each phase, and what actions it would take as levels of financial stress increase. Given the lead-in times required to deploy different management or recovery actions, it is important to understand how MDB stress is likely to materialise. This should be supported by reverse stress-testing analysis and assessment of the impact that any management action is likely to have on remediating the situation (see Chapters 3 and 4).

Defining MDB non-viability: why it is important and how to assess it

A key concept required to improve clarity on the MDB crisis continuum is how to assess when an MDB might be judged to have reached the point of non-viability. The point of non-viability is reached when an MDB is deemed no longer viable today or on a forward-looking basis. It denotes the difference between an MDB being a ‘going’ or a ‘gone’ concern. Absent a clear framework to assess whether an MDB is non-viable, it is difficult for MDBs to manage their operations to avoid such conditions. This is relevant for when a

capital call might be triggered (see Humphrey, 2024) as well as for new MDB hybrid capital instruments, which denote a call on callable capital as their write-down trigger. For callable capital to be available on a going-concern basis, a clear framework for determining when an MDB is non-viable or likely to be is required. If the hybrid market is to develop and support MDB credit growth, the experience of developing similar debt capital markets for commercial banks over the last decade suggests that clarity on the important loss-absorbing features of such instruments is critical. Equally, the recent write-down of Credit Suisse Additional Tier 1 debt capital instruments suggests that a lack of clarity results in legal challenges if write-down triggers are exercised (for more details, see Financial Stability Board, 2023).

Non-viability for commercial banks is often described with reference to minimum conditions of authorisation or breach of minimum regulatory requirements (for example, 8% core capital adequacy ratios (CARs) for large banks or lower for smaller non-systemic banks) without the ability to restore compliance in a reasonable timeframe. For many large banks, a breach of this 8% CAR trigger would be consistent with a loss of 50% or more of the bank's capital resources. Whatever the actual trigger, it would need to activate sufficiently early in any institution's financial distress to recognise that capital reporting is a backward-looking and point-in-time assessment sensitive to model uncertainty and assumptions. That is to say, if a bank loses 50% of its capital resources and breaches an 8% CAR ratio, it is likely that more losses are to be expected on a forward-looking basis. Any reliance on capital reporting as a basis for assessing non-viability needs to reflect these limitations. In particular, MDBs must recognise that non-viability thresholds are likely to be breached much earlier than the triggers for balance sheet or cashflow insolvency. The MDB non-viability trigger should not be when capital resources are equal to zero; instead, the trigger should activate much earlier.

An approach to defining MDB non-viability is required. Any definition of non-viability could take into account existing MDB capital target methodologies and be linked to losses under these existing MDB capital adequacy frameworks. For example, this could be when an MDB loses 50% of capital resources and cannot recapitalise in a reasonable timeframe. However, the actual triggers will require further analysis by MDBs in terms of what is necessary to maintain continuity in their lending services under extreme stress, given the risk profile of their balance sheet. Some MDBs point to the notional amount of non-accruing loans exceeding equity as a possible indicator of extreme financial stress for an MDB. In such a scenario, the MDB would be on an unsustainable trajectory if recovery actions were not taken to avoid its non-viability. Regardless of which capital triggers are considered most relevant, the assessment of MDB non-viability should include two conditions:

- Condition 1 – Is the MDB failing or likely to fail in the future (that is, has it breached MDB minimum capital thresholds)?
- Condition 2 – Has the MDB exhausted all means at its disposal to recover its position (that is, to restore its compliance again with minimum MDB capital thresholds)?

The second condition could include assessing the credibility of MDB recovery actions, like shareholder capital injection, callable capital or other approaches to enhancing the financial resilience of MDBs, including the Perpetual Bond Facility proposed in Chapter 3 or hybrid capital write-down. If both conditions are met, then the MDB should be considered to have reached, or likely to reach, the point of non-viability. An MDB should be considered as a going concern and not be judged non-viable as long as the two conditions are not met simultaneously. For example, an MDB could breach an internal minimum capital threshold (for example, loss of 50–60% of existing capital resources), but not be considered non-viable as long as it has a reasonable prospect of taking action to recover from this severe financial distress.

Any measure of non-viability needs to consider the fact that MDB business models are unique and exposed to different balance sheet and financial stress dynamics. For example, while the MDB business model is low risk, it is also not extensively diversified, which may limit its ability to respond to stress scenarios. As things stand today, MDBs have limited recovery actions available compared to commercial banks. While MDBs can increase interest charges to borrowers as a response to stress, such options may be in tension with the viability of the MDB business model and the developmental objectives of MDB lending. MDBs are also unlikely to be able to sell assets given the absence of a liquid market in sovereign loan exposures, or accept the destructive capital impact of disposals at significant discounts to par value. In a stress, MDBs may be fragile, given the lack of recovery options. This is an important consideration when MDBs are defining appropriate triggers for MDB non-viability. That is to say, while MDBs are low risk, their lack of capacity for recovery might suggest management action is needed at an earlier stage in the stress continuum than would be the case for commercial banks.

Managing MDB stress – a Proactive Intervention Framework

MDB management needs reporting and governance arrangements to monitor and judge relative proximity to non-viability, to be able to identify risks and take timely recovery actions that are proportional to the stress they are experiencing. MDBs' judgements of their position

can then be expressed by assigning a score derived from individual risk elements; for example, capital adequacy, liquidity buffers, operational risk, etc. An increasing score means increasing MDB stress.

The scoring process is designed to ensure that MDB management: 1) identifies risks to viability early; and 2) takes appropriate action to reduce the probability of becoming non-viable at an early stage. These scores are often called Proactive Intervention Framework (PIF) scores². This score also enables shareholders to take any supporting preparatory actions based on the MDB’s assessment of its proximity to non-viability. Shareholders should engage with MDBs to ensure that thresholds or indicators from moving from one PIF score to a higher score are standardised across MDBs.

There could be five PIF stages, each denoting a different level of proximity to non-viability or failure. When an MDB moves to a higher PIF stage, this indicates that the MDB’s viability is deteriorating. PIF stages run 1 to 5, with 1 signifying low or no risks to the viability of the MDB and 5 a MDB that has reached the point of non-viability. Decisions to increase the score allow MDB management to consider and deploy appropriate control and recovery actions. The PIF score should be regularly updated (for example, annually, with an interim review every six months). These scores can provide a powerful reporting tool and over time, will become the means for summarising the overall risk position of the MDB to executive management and shareholders.

Figure 2 **MDB proactive intervention framework stages**

Stage 1	<u>Low risk</u> to Viability of MDB
Stage 2	<u>Moderate Risk</u> to Viability of MDB
Stage 3	<u>Risk to viability</u> of MDB
Stage 4	<u>Imminent risk</u> to viability of MBD
Stage 5	MDB become <u>Non-viable</u>

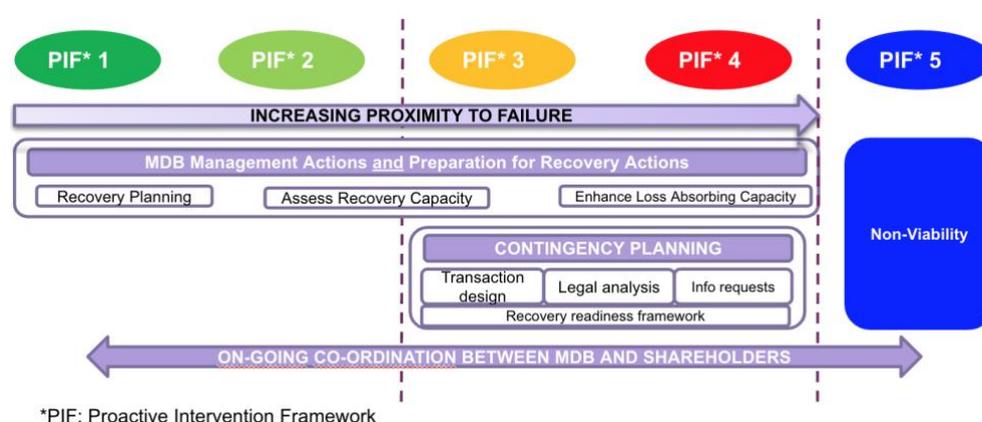
When the MDB is in good financial health (Stages 1–2), MDB management should put in place the recovery planning arrangements on which it will rely in a crisis. MDBs should agree with shareholders on the appropriate level of recovery capacity to maintain to respond to different types of financial stress. The level of recovery capacity

² See Basel Committee on Banking Supervision (2018) Frameworks for early supervisory intervention for more background information.

required is a matter of judgement and should be based on reverse stress-testing analysis.

Once MDB stress has been identified (for example, Stages 3–4), MDB management must ensure it has the ability to take appropriate remedial action to reduce the likelihood of non-viability. If the MDB gets to Stages 3 and 4 of the PIF, it should consider deploying actions described in the MDB recovery plan (see the next section). The PIF provides the governance and coordination arrangements necessary to enable MDB management to judge when recovery action of increasing materiality needs to be deployed. Figure 3 illustrates how the actions of MDB management change as the PIF score increases.

Figure 3 MDB life cycle, PIF scores and management actions



Although PIF scores would not be disclosed to the market or MDB counterparties, who must make their own assessment of MDB viability, the establishment of PIFs as part of their risk management frameworks will demonstrate to the market the preparedness of MDBs to respond appropriately to different levels of financial stress.

See **Appendix 2** for an illustration of the stages of an MDB Proactive Intervention Framework.

2.3 MDB recovery planning – what is it, and why is it important?

In the words of Benjamin Franklin, *'by failing to prepare, you are preparing to fail'*. Any financial institution, including those with a low-risk business model such as MDBs, must be adequately prepared for financial stress. A lack of MDB preparation for stress scenarios can make it difficult to implement measures to restore the institution's financial strength with the speed required to reassure financial market counterparts. It can also mean that recovery actions on which an institution planned to rely take longer to implement than

anticipated or are dependent on cooperation from a third party that was not anticipated. This lack of investment in developing the capacity to respond adequately to stress can significantly amplify the impact of stress, increase risk to shareholders, and, in a worst-case scenario, result in failure.

Recovery planning requires that all financial institutions have clear and tested strategies for recovering from a range of potential stresses. This involves establishing an early warning system to alert them that a stress is approaching. A key principle of an institution's recovery plans is that they focus on ensuring management identifies actions it can take independently to restore its position and should not assume or require any taxpayer support. Recovery plans have become a core part of financial institutions' risk management frameworks and best practice.

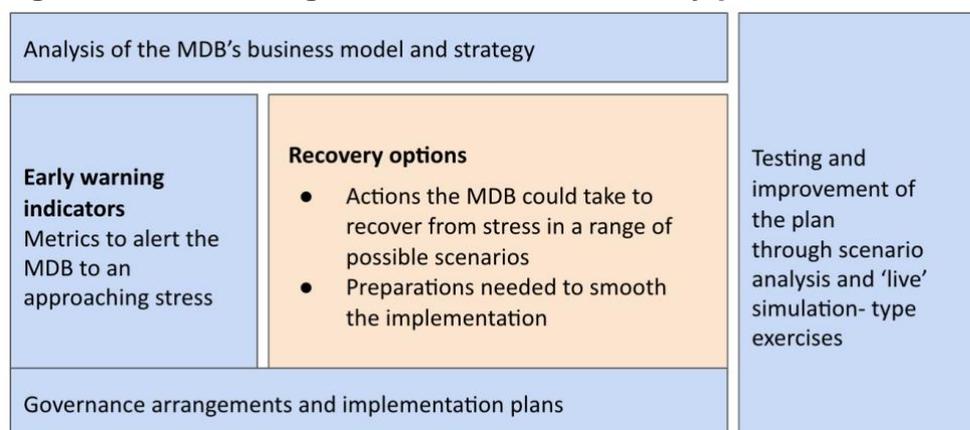
The development of recovery capacity helps ensure resilience to financial distress. It is typical for recovery plans to be based on a range of internal (for example, changes in loan pricing) and external (for example, asset disposals) actions to generate capital and liquidity that are available to the executive institution independently. Such actions can also include requiring additional shareholder support. The FSB suggests that recovery plans should include:

- credible options to cope with a wide range of scenarios, including both idiosyncratic and market-wide stress;
- scenarios that address capital shortfalls and liquidity pressures; and
- processes to ensure timely implementation of recovery options in a range of stress situations.

Recovery planning increases the resilience of any financial institution to stress and reduces the probability of its failure. MDBs need to have options to restore their financial resilience beyond relying only on future shareholder capital injections. This would enable MDBs to maintain better continuity in the important lending functions they provide to borrowers around the world and to be able to do so throughout the economic cycle.

Developing MDB recovery plans

An effective recovery plan should allow an MDB's management to restore the business to a stable and viable position in a timely manner. The plan should set out all credible options that the MDB has to respond to a variety of scenarios. An MDB needs to be able to respond to market-wide stresses, idiosyncratic stresses, or both simultaneously.

Figure 4 Building blocks of MDB Recovery plans

MDB recovery planning needs to be consistent with the business strategy agreed with shareholder governments. It is in the MDBs' interests to have a thorough understanding of the recovery options available in a crisis, so that they can escape trouble before creating a risk for their shareholders, undermining their lending capacity to borrow or risking failure. A recovery plan should be reviewed and signed off by the MDB's accountable executives and the board. In the event of a crisis, MDB executives would need to be able to implement agreed recovery actions to respond to stress and coordinate with the board and shareholders.

MDBs should think about the options that would be used in different scenarios, when they would be deployed, and how they would be selected so that if a crisis occurs, swift action can be taken. Options range from internal actions such as capital conservation through cost cutting or slowing lending growth, to those that are highly visible externally, such as additional capital injections by shareholder governments, the write-down of hybrid capital instruments, or the calling of callable capital guarantees of MDB senior bondholders.

Constructing a recovery plan is useful in itself. Considering available recovery options forces an MDB to think about its vulnerabilities, while modelling how the financial position might change in a stress situation can help identify changes that need to be made to improve the resilience and 'recoverability' of the MDB. The MDB needs to have options with sufficient aggregate impact to recover from a range of potential stresses or to buy time to implement more extreme recovery measures. MDBs must consider more radical options they might need to take in a crisis (such as significantly reducing lending) and not just those that are currently easy to implement.

A credible recovery plan must be implementable in a stress environment, and the MDB must be willing and able to use it. This relates to the culture in the organisation: the bank must recognise the need to develop and maintain a credible plan and actually use it if necessary. The main components of a credible plan are:

- effective early warning indicators;
- a range of recovery options appropriate to the business model;
- governance arrangements for both the production and invocation of the plan;
- a communications plan to deal with internal and external stakeholders;
- scenario testing of the plan; and
- sufficient analysis to demonstrate the credibility of the plan, including its suitability for the MDB's business model.

Most recovery actions will have both a capital and liquidity impact, but this will not necessarily be positive in both respects. For example, disposing of a portfolio of assets at a loss would generate liquidity, but might erode the capital position if the loss more than offsets the reduction in assets. Such an option may be appropriate for a liquidity stress, but less suitable for a scenario that threatens the bank's capital position.

MDBs cannot predict and prepare for every possible situation. But testing the recovery plan against a range of hypothetical scenarios can help identify problems with the plan under different types of stress. Scenario testing is a useful way to demonstrate how the different parts of the recovery plan would interact. This includes understanding the point at which recovery indicators would be triggered and whether they are appropriately calibrated, how the escalation and governance procedures would work, and the potential dependencies between recovery options.

Recovery planning is most effective where the board members and executives in an MDB engage with developing the plan and where the plan is owned by the most senior people in the organisation, for example, the chief finance officer (CFO) or chief revenue officer (CRO). If MDBs treat recovery planning as a compliance exercise, then it has little value; the plan must give the bank the best possible chance of recovering if a stress hits. The absence of such a plan is likely to make the point at which an MDB loses access to wholesale funding markets in a stress situation occur sooner than it otherwise would if it had developed adequate crisis management and recovery capacity. See **Appendix 3** for more details on each of these components.

How much recovery capacity do MDBs need and what does it look like?

How much recovery capacity MDBs create is a matter of judgement driven by their assessment of the likelihood of stress. To date, in

practice, MDB recovery options have been limited to requests for additional shareholder capital injections. However, capital injections by sovereign governments may take time to arrange and require shareholder governments to achieve consensus. It is difficult for MDB management to hardwire in advance of a stress as part of a recovery plan. While MDBs should be able to improve clarity on the conditions that would need to be met to request a capital injection or the process related to it, it will always be a contingent option subject to decision-making by sovereign governments.

In the face of financial stress, MDBs could choose to reduce demand for capital/liquidity by reducing their lending. However, such recovery actions are inconsistent with the policy purposes of MDBs. Recovery planning best practice would suggest that recovery actions that are inconsistent with the business strategy are difficult to implement and not a credible source of recovery capacity.

MDBs maintain relatively large liquid asset buffers, which could be considered a form of liquidity recovery capacity. Rapid securitisation of MDB assets could provide a recovery action as an alternative to reliance on unsecured wholesale funding markets. However, to date, MDBs have not engaged in securitisations in any material manner, which limits their capacity to rely on such options as a liquidity recovery option. Callable capital provides an important liquidity recovery option to facilitate the repayment to bondholders. However, the timing of the availability of callable capital and triggers for an MDB requesting it are not well defined; however, they would probably take place late in the MDB crisis continuum. These issues must be thoroughly addressed (as per Humphrey, 2024) before callable capital can be systematically embedded into MDB recovery planning.

There are two examples of temporary financial support provided by Canada to the Inter-American Development Bank (IDB) and South Korea to the African Development Bank (AfDB) at short notice to shore up their respective financial positions in order to maintain their credit rating. These examples of external support were in response to a much more benign level of MDB stress than that envisaged for recovery planning purposes. That said, these cases are useful to show that MDBs have taken innovative action to improve their financial position in the past, which provides some useful examples in taking forward recovery planning. See **Appendix 4** for more details on both cases of temporary callable capital. The Perpetual Bond Facility discussion in Chapter 3 could be considered an example of in-crisis support that could be established on an ex-ante basis with willing shareholder governments.

Ultimately, the level of recovery capacity that MDBs choose to maintain is a matter of risk appetite and judgment for MDB management and, ultimately, their government shareholders.

2.4 MDB capital structure – purpose in financial stress

Any development of MDB recovery capacity or enhancements to the broader financial resilience of MDBs should be based on a clear understanding of the MDB capital structure. MDB statutes formally divide their capital structure into ‘paid-in’ capital and ‘callable’ capital. With a nominal value of \$880 billion across the eight largest MDBs, callable capital represents more than 90% of the subscribed shareholder capital for most MDBs.

In the absence of external capital regulations, a key constraint on MDB capital adequacy frameworks is the need to maintain the AAA credit rating needed to access the wholesale funding markets on which the business model entirely depends. This has often meant that credit rating methodologies – rather than questions related to MDB capital structure – have predominated.

MDB capital structure

Capital, in its simplest form, is the stock or equity that represents the owners’ stake in the lender. It represents the portion of the value of a lender’s assets that is not legally required to be repaid to anyone or only to do so far in the future (for example, hybrid capital or other forms of subordinated debt). The value of a bank’s capital is the difference between the value of its assets and the value of its liabilities. In transforming wholesale borrowing into loans for borrowing countries, the MDB business model entails taking on both credit risk and liquidity risk.

Credit risk is the risk that a borrower cannot repay what is owed to the MDB. Defaults cause the MDB to make a loss, which comes out of retained earnings. These, in turn, are part of the MDB’s equity base. For example, on the MDB’s balance sheet, as these loans become non-performing or default, the value of the assets falls to reflect the new value of the loans. If an MDB has retained earnings from previous years, it can use these to pay off debts when the proceeds from its assets are insufficient. The MDB can remain solvent because the initial losses are balanced by reducing the MDB’s capital value. From a cashflow perspective, if an MDB becomes unable to both pay all its creditors and retain earnings and make dividend payments to stockholders, debts are repaid first. Capital acts as a buffer for losses and helps an MDB avoid insolvency despite incurring loan losses.

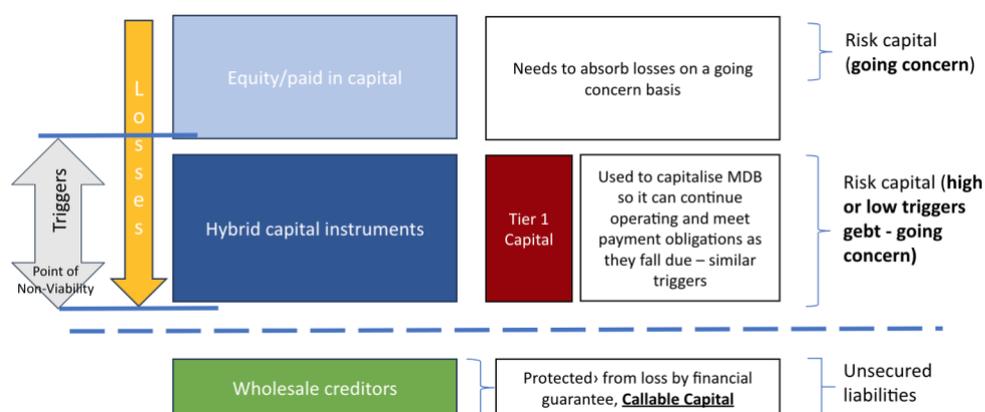
The liquidity risk of an MDB is the risk that a large number of investors are unwilling to fund the MDB, leaving it short of funds. Such situations can force MDBs to sell liquid asset portfolios, possibly at unfavourable prices, when they would not otherwise choose to do so. This can reduce the bank’s capital, making it unable

to repay senior bondholder creditors what they are owed as these debts fall due; this means it is 'cashflow insolvent'.

MDBs bondholders have an additional, unique layer of protection provided by callable capital, a shareholder government guarantee of bondholder liabilities. Callable capital is not a 'capital' instrument despite what its name might suggest. Because callable capital can only be used to repay bondholders, it does not meet the typical eligibility features of a capital or loss-absorbing instrument. For example, these features include being fully paid in and available to absorb credit losses. Such criteria are the characteristics that must be met in order for the instrument to be considered capital relative to the policy purposes of those instruments and are as relevant for MDBs as they are for commercial banks. Other operational aspects of callable capital, including the timing of its availability and the approach of shareholder governments to honouring this guarantee, are not well understood or transparent. All these factors suggest that callable capital, as it is structured today, only provides protection to bondholders in certain circumstances and it is not a source of solvency support for MDBs.

Figure 5 provides an illustration of the relative ranking of different MDB capital instruments (that is, with equity as the most junior in the creditor hierarchy), when they absorb losses (that is, while the MDB is a going versus a gone concern) and how they relate to the role of callable capital as currently defined.

Figure 5 MDB liability structure – illustration of relative ranking of instruments



MDBs capital structure: challenge presented

As discussed above, if MDBs lack sufficient high-quality and loss-absorbing capital instruments, it can mean that if MDBs experience stress, they will be exposed to a loss of wholesale market confidence more quickly. This will force MDBs to consider at that point how to rebuild their common equity capital bases in the middle of the crisis. Such late-stage actions are likely to amplify the crisis and prolong its

length, and depend on the willingness and ability of shareholders to contribute more capital quickly. Therefore, it is important to consider the capital structure of any financial institution during both good and stress conditions in advance of the stress and agree how to put in place the necessary resources ex-ante.

Defining an MDB capital structure and overcoming challenges

We must consider what changes could help improve the financial resilience of MDBs, allowing them to expand their lending capacity today while also improving their ability to respond to future financial distress. MDBs should consider such questions as part of the development of MDB recovery plans, as outlined in the discussion in this paper. The development recovery capacity should attempt to provide clarity on the following points.

- Clarifying the timing of callable capital – If callable capital is expected to play its role in reassuring bondholders, then the timing of its availability needs to be defined (that is, is it a going- or a gone-concern instrument?). If MDBs are to incorporate callable capital into their capital adequacy frameworks, then it most likely needs to be available on a going-concern basis. Without this, it is unlikely to change wholesale investor behaviour in the required manner to allow MDBs to expand or maintain their balance sheets without increasing their proximity to non-viability.
- Clarifying the nature of callable capital – How callable capital would be injected following a call could be clarified. This may also assist in achieving the incorporation of callable capital into MDB capital adequacy frameworks, but also potentially into their capital structure. For example, if it was clarified that callable capital would be injected following a call in the form of capital as opposed to liquidity to repay bondholders only, then this could expand the number of capital quality criteria callable capital might be able to meet and, potentially, along with other clarification, this could allow it to be recognised in some form in MDB capital structures.
- Expanding MDB capital recovery options – Recovery planning means developing a menu of capital and liquidity recovery options with a clearly defined financial impact. For recovery plan options to be considered credible, the preconditions for operationalising those options and the associated timeline for realising their benefit should be fully understood and robust. Although it is reasonable to include additional shareholder paid-in capital as a recovery option, it may be difficult for MDBs on their own to enhance the certainty or deliverability of such options. Therefore, MDBs should continue to explore the role of additional capital instruments like hybrids, possible reforms to callable capital and other innovations that achieve the objective of enhancing financial resilience, recognise the fiscal constraints on shareholders, and

are consistent with the low margin business model of many MDBs.

Chapter 3 sets out a new proposal to improve MDB recovery options and increase overall lending capacity.

3 A recovery option that improves lending: Perpetual Bond Facility

In 2009, the Pittsburgh G20 leaders' communique noted that G20 finance ministers 'should consider how such mechanisms as temporary callable and contingent capital could be used in the future to increase MDB lending at times of crisis'.³ These efforts remain as relevant today as they did in 2009, particularly with persistent crises that impact MDBs' objectives.

This chapter presents a possible option to enhance MDBs' capital structure and lending capacity by developing an alternative capital instrument, termed a 'Perpetual Bond Facility'. MDBs should explore opportunities to test and develop pilot versions of such alternative capital instruments with one or more shareholder governments to demonstrate the proof-of-concept and clarify the treatment by credit ratings of such a facility.

3.1 New Perpetual Bond Facility – a proposal

This paper proposes that MDBs consider developing a new type of financial instrument that helps achieve modernisation of their capital structure, improves resilience in crisis and supports credit growth, termed a Perpetual Bond Facility (the 'Facility'). The Facility is a contractual commitment between an MDB and a group of shareholders that the shareholders will buy perpetual bonds (PBs) issued by the Facility in the event of MDB stress or a non-viability event, thereby recapitalising and stabilising the MDB. The shareholder governments subscribing to the Facility will need to be considered highly creditworthy – for example, non-borrowing shareholders with high credit rating.

The PBs issued by the Facility would qualify as MDB core Tier 1 capital once issued. The PBs could supplement the roles of paid-in capital and callable capital (CC) in MDB capital adequacy frameworks (CAFs). The PBs would support both solvency and liquidity risk, complementing paid-in capital and callable capital, but

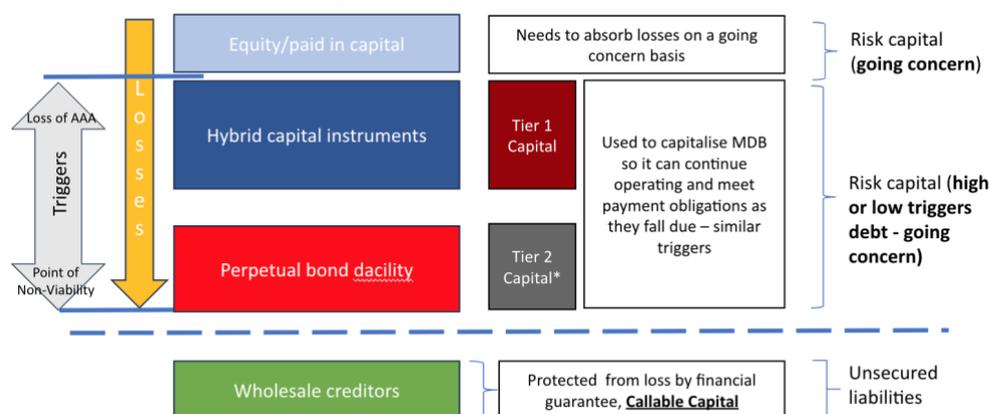
providing additional benefits over CC, which covers liquidity risk for bondholders. The PBs issued to shareholders are non-voting instruments and therefore would not change MDB governance arrangements.

The nominal size of the Facility can be agreed at any level between the MDB and subscribing shareholders. To maximise its effectiveness in enhancing MDBs' crisis management and recovery capacity, the nominal size of the shareholders' commitment to purchase PBs should be sufficient to restore MDB solvency from the point of non-viability to a level of capitalisation consistent with continuity of access to wholesale funding markets at sustainable prices.

If PBs were issued under the Facility, shareholders would hold an interest-bearing asset to make the cost of buying PBs neutral or modestly positive, provided that interest payments are being made. Subscribing to the Facility today would not require shareholders to appropriate funds, as the probability of MDB stress remains low. Like CC today, the shareholders' liability as a subscriber to the Facility should remain a remote contingent liability in their public accounts.

The aim of the Facility is to provide contractual certainty to MDBs of shareholder support in a stress and to smooth any related operational steps related to providing support should the risk crystallise. Despite being an unfunded contingency commitment, the nominal amount of the Facility should be considered a form of MDB Tier 2 capital if certain conditions are met. Such conditions would include the need for the PBs to qualify as Tier 1 capital once issued. In addition, the shareholders' commitment to purchase the PBs once pre-agreed financial indicators of stress have been met would need to be on demand and not subject to any further conditions. That is to say, the requirement for shareholders to purchase PBs would need to be legally binding. This obligation would need to be supported by an independent legal enforceability opinion. These conditions are important, as they provide the basis for the Facility to achieve Tier 2 capital treatment and thereby directly support MDB credit growth today.

Figure 6 MDB liability structure, including PB facility ranking relative to MDB capital



* See Part 3 for more detail - The perpetual bonds issued by the Facility once triggers were met would qualify as Tier 1 capital

There are precedents for this type of unfunded capital commitment in the insurance market under Solvency II in the form of ‘ancillary own funds’.⁴ To reflect the contingent nature of the Tier 2 capital support, the eligibility of the Facility as Tier 2 to contribute to MDB minimum capital targets could also be capped. For example, the Facility providing Tier 2 capital support could contribute up to 20–30% of the capital required to meet minimum capital ratios or targets. In the case of the International Bank of Reconstruction and Development (IBRD), for example, this would allow the Facility to support additional lending capacity of between \$50 and 75 billion based on current IBRD paid-in capital resources.

The Facility is also designed so that if after issuing PBs to stabilise an MDB experiencing financial stress, the MDBs’ financial position improves and it again meets a predefined level of capitalisation or capital targets, the MDB has the option to repurchase the PBs from shareholders. This would reverse the support measure provided by shareholders by retiring any PBs issued and restoring the capacity of the Facility as a form of Tier 2 capital, as well as its capacity to respond to other stress events in the future.

In summation, the Facility essentially formalises temporary MDB support measures that have been provided in the past (for example, see **Appendix 4** on ad hoc temporary callable capital by Canada and South Korea). This should be recognised by credit rating agencies as a contribution to the capital strength of MDBs, and it is intended to increase MDB lending capacity today. Further details of the Facility

⁴ Solvency II defines ‘ancillary own funds’ as comprising any legally binding commitment received by undertakings in the form of a capital instrument that, if called up, will generate an asset, often in the form of cash, while simultaneously creating corresponding interests in the insurance or reinsurance undertaking in the case of shares, or corresponding subordinated liabilities of the undertaking. See www.eiopa.europa.eu/publications/guidelines-ancillary-own-funds_en#files

design features are provided in an illustrative Facility term sheet in **Appendix 1**.

3.2 Perpetual Bond Facility proposal – benefits

The Facility has several important benefits considered from the perspective of a range of different MDB reform priorities, as follows:

- MDB capital position – The Facility would expand the ability of MDBs to manage both solvency and liquidity risk. The PBs, once issued in a stress, would qualify as Tier 1 or core capital and improve its going-concern resilience to financial stress. MDBs can use the funds raised by issuing PBs to cover losses or repay creditors. MDBs should be able to adjust their CAFs' risk-appetite ratios to reflect the significant increase in certainty that they can manage stress.
- MDB resilience to stress and recovery capacity – The availability of the Facility would significantly enhance MDBs' recovery plan capacity and demonstrate to the wholesale funding markets their capacity to remain a going concern, even in the event of extreme financial stress or non-viability. The issuance of PBs could also be triggered pre-emptively on the identification of an agreed stress/trigger being met or likely to be met based on forecasting within 12 months; for example, an equity to loan ratio that is indicative of stress that might lead to non-viability if unchecked.
- MDB as a development lender – The nominal value of the Facility would qualify as Tier 2 capital and thus support an expansion of MDB lending capacity today. This Tier 2 capital could contribute up to 20–30% of the capital required to meet minimum capital ratios or targets and fund new lending.
- Shareholder governments' exposure to MDBs – The Facility does not require any change in the scale of the contingent liability for governments, as the risk of a call remains unchanged. Instead, what the Facility changes is the operational certainty with which shareholder support will be provided once certain predefined triggers related to stress are met. Indeed, while the Facility does not change any MDB statutes, in practical and financial terms, the size of the PB facility would reduce the shareholder government-related treaty based contingency liability with respect to CC treaty-based obligations. On issuance of a PB, shareholders will have coupon-earning assets in the MDB; that is, shareholders make a return as long as coupon payments are being made.
- Wholesale debt investor – The binding contractual nature of the Facility would provide clarity on shareholders' commitment to ensure MDBs are resilient to stress in terms that leverage capital markets mechanisms and contractual arrangements.

- **Credit rating** – The Facility would provide MDBs with a contractual right to issue bonds to shareholders, which represents a significant increase in MDBs creditworthiness. For example, the Facility could be sized to have sufficient capacity to restore MDB core capital to a level necessary to maintain access to wholesale funding markets at sustainable prices, even if all existing capital reserves were to be wiped out. Such a Facility would be consistent with the maintenance of the AAA rating.

The key difference between MDB hybrid instruments issued to shareholders and the Facility is that the former is paid-in and has an immediate fiscal implication for the government balance sheet. Both hybrids and the Facility are designed to absorb MDB losses and support credit growth. The trigger for both hybrids and the Facility would be the extreme financial distress of an MDB. However, the Facility can achieve these outcomes without requiring shareholder governments to invest funds today; instead, it would only require the funds to expand MDBs' capital base in the event of a financial stress. For some governments with competing priorities for fiscal resources today, this may give the Facility a distinct advantage over hybrids.

3.3 Operationalising the Perpetual Bond Facility – next steps

The design of the Facility proposal has benefited from informal feedback and design suggestions from several major capital markets law firms and investment banks with expertise in capital eligibility and the design of comparable instruments used today in other sectors, including the insurance sector. Its design also reflects the feedback of people familiar with credit rating agency evaluation processes for similar capital structures in other sectors and in rating MDBs.

As a next step, MDBs will need to progress the design of the Facility, leveraging their own internal and external legal and capital markets advisers to develop a fully operational proposal for MDBs and shareholder governments to consider. It is recommended that an MDB could develop a pilot version of the Facility with one or more shareholder governments. Building on the Facility term sheet in **Appendix 1**, the pilot Facility should also consider the following design features:

- A description of non-viability as a trigger for the issuance of the PBs that considers the need to maintain continuity in MDB critical lending services, that is, before balance sheet/cashflow insolvency.
- The definition of clear capital triggers on which the non-viability assessment would be based.

- A description of how the trigger for the Facility would interact or relate to triggers for other MDB recovery actions, including hybrid write-down or callable capital.
- The MDB governance, monitoring and reporting arrangements that will be used to make the judgement whether the Facility triggers are met or not.
- A description of the MDB's approach to disclosing the establishment of the Facility as part of its recovery plan, which is necessary to capture the benefit of increased wholesale market confidence in MDB resilience related to the Facility.

This work should aim to present a structured proposal to credit rating agencies to confirm the treatment of the PB as core capital if issued in a crisis and the Tier 2 capital treatment of the nominal value of the Facility itself. Once the proof of concept has been established, it is recommended that MDBs engage with several higher-rated, non-borrower shareholder governments to confirm the public accounts treatment of obligations under the Facility is the same as existing callable capital arrangements and is considered a remote contingent liability.

The Facility can be integrated into the MDB's capital adequacy frameworks and recovery planning arrangements in different ways, depending on how it is designed. Any approach will need to consider a range of objectives, including MDB capital adequacy and lending capacity, MDB resilience to crises, the credibility of the Facility with wholesale investors, and shareholder government exposures to MDB and public accounting treatment. There are three possible options to integrate the Facility into existing arrangements of an MDB: 1) the Facility could be considered an internal operational arrangement or procedure to facilitate the execution of a call on callable capital and agreed as such with all shareholders in advance; 2) it could be treated as a new standalone recovery option; or 3) the Facility could be designed with an explicit description of the interaction with participating shareholders' commitments under callable capital arrangements.

4 Enhancing MDBs resilience: role of Expert Advisory Panel

Developing additional MDB financial resilience and crisis management capacity requires investment by MDB management. It will take time and management's attention to establish the modelling, reporting and internal monitoring arrangements, as well as design credible recovery actions that are sufficient to recapitalise MDBs in stress or at the point of non-viability. Shareholder governments often do not have the same level of expertise as MDBs' management on the risk of their lending operations. This can mean a disconnect between the level of credit risk that MDBs are able or willing to take and the expectations of shareholder governments. There may be tensions between shareholders' interests in increasing lending capacity, MDBs maintaining a AAA credit rating with all three credit rating agencies, and ambiguity in MDB callable capital triggers. In particular, the absence of adequate financial resilience and recovery planning capacity in MDBs may be expressed in a conservative approach in setting risk appetite in MDB risk management frameworks.

A new Expert Advisory Panel could be established to advise shareholder governments on the effectiveness of MDB financial resilience and recovery options in times of stress. The panel would support shareholders to assess the risk to their equity (paid-in and callable) as part of MDB regular business planning cycles and the implications for MDB lending capacity. Overall, enhancing MDB resilience to stress will likely result in a stronger MDB sector that can better advance the development policy objectives of shareholder governments through expanded lending capacity. The panel will help shareholders overcome their expertise gap and help them assess the suitability of the financial resilience and recovery capacity. The primary objective of this panel would be to support shareholder governments and MDBs in calibrating their risk-appetite judgments, as expressed through the adequacy of MDB financial resilience as part of the MDB three-year business strategy setting process. The panel would provide shareholders with an annual update on implementation progress, the implications for shareholder risk appetite and MDB lending capacity. The funding for any such Expert Advisory Panel should be agreed between shareholders and MDBs

as part of the three-year business planning cycle. Recommendation 5A of the G20 CAF report also stresses the need to consider options to strengthen the ability of shareholder and MDB management to set risk appetite, develop MDB capital adequacy policies and oversee their implementation (G20 CAF Panel, 2022).

It is recommended that the panel should be composed of representatives familiar with designing and implementing proportionate approaches to enhancing financial institutions' resilience to stress or non-viability. It should include individuals with a background in the following areas:

- reverse stress-testing and risk calibrations in capital adequacy frameworks;
- international best practices in financial crisis management;
- financial institution recovery planning, including stress monitoring, trigger frameworks, and developing recovery options;
- capital reform, with a particular focus on the role of loss-absorbing capacity at the point of non-viability, including approaches to balance sheet recapitalisation in stress; and
- MDB callable capital and other resilience tools.

The Expert Advisory Panel would be designed to advise shareholder governments on agreeing MDB business strategy. It could also provide a forum for cooperation and information exchange between MDBs on options for strengthening the financial resilience of MDBs to stress events. Such cooperation could support a consistent approach of MDBs and the sharing of sound practices that maximise MDB resilience, as well as lending capacity. Such dialogue between MDBs and panel members would help bridge the knowledge gap on recovery planning within MDBs and shareholder governments overtime. It could also improve a joint understanding of how key MDB and shareholder choices impact MDB risk appetite as part of business strategy setting processes.

5 Conclusions

If MDBs are to expand their balance sheet to meet the development challenges of the future, they need to consider what actions to take should they experience financial stress or risk reaching the point of non-viability. This is necessary as MDBs provide important lending services that are critical in the economic development of many borrowing countries. As a result, MDBs need to have the necessary arrangements in place to ensure that these credit provision services continue under normal and stressed market conditions.

Any financial institution, including those with a low-risk business model such as MDBs, needs to be adequately prepared for financial stress. Credible MDB crisis management arrangements are also aligned with minimising risk to shareholders and ensuring continuity of access to wholesale funding markets. The financial resilience of MDBs would be greatly enhanced by recognising that liquidation is not an appropriate paradigm for MDBs given the critical nature of the lending services they provide. A clear description of the MDB crisis continuum and definition of the point of non-viability for MDBs are important foundational components of MDB crisis management capabilities. Defining non-viability triggers will require MDB management to have reporting and governance arrangements in place to monitor and judge relative proximity to those triggers. Having developed the ability to assess and identify proximity to non-viability, MDBs should develop their crisis recovery planning capacity to increase resilience to stress and reduce the probability of failure. MDBs should continue to develop pilot versions of alternative capital instruments with one or more shareholder governments to enhance their recovery capacity.

Such reforms will strengthen market confidence in MDB resilience today and support their future growth. However, unlocking this expanded lending capacity depends on MDBs implementing a multi-year reform programme to deliver changes that have become mainstream in the commercial banking world since the 2008 global financial crisis. To support shareholders in assessing the credibility of MDB recovery capacity, MDBs and shareholders should consider how to access the required expertise to properly monitor and assess enhancement to MDB financial resilience arrangements.

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Appendix 1 MDB Perpetual Bond Issuance Facility (the ‘Facility’)

This appendix describes a new type of financial transaction for MDBs designed to enhance loss-absorbing capacity (or capital structure) that could supplement paid-in capital and callable capital (‘CC’). The Perpetual Bond Issuance Facility is a commitment by shareholders to buy perpetual bonds (PBs) that can qualify as core Tier 1 capital in the event of stress, and as Tier 2 capital otherwise. The PBs support both solvency and liquidity risk, whereas the existing CC only covers liquidity risk for bondholders. The PBs are non-voting instruments.

The Facility has contractual certainty but remains an unfunded commitment unless utilised. This additional certainty should be recognised by credit rating agencies as a contribution to capital strength and should increase MDB lending capacity. If the Facility were used, shareholders would hold an interest-bearing asset to make the cost of buying PBs neutral or modestly positive when coupon payments are made. Subscribing to the Facility would not require shareholders to appropriate funds,⁵ while the MDBs continue to retain the highest credit ratings as the probability of stress would remain low.

There is a precedent for this type of unfunded capital commitment in the insurance market under Solvency II in the form of ‘ancillary own funds’.⁶ The Facility is also designed to be reversible in the event of an MDB recapitalisation. It essentially formalises any temporary support measures that might have been contemplated in the past.

⁵ Like CC, the Facility would remain a remote contingent liability in shareholders’ public accounts.

⁶ Solvency II defines ‘ancillary own funds’ as comprising any legally binding commitment received by undertakings in the form of a capital instrument that, if called up, will generate an asset, often in the form of cash, while simultaneously creating corresponding interests in the insurance or reinsurance undertaking in the case of shares, or corresponding subordinated liabilities of the undertaking. See www.eiopa.europa.eu/publications/guidelines-ancillary-own-funds_en#files

Transaction details

Borrower:	Multilateral development bank ('MDB')
Lenders:	Any group of existing shareholder(s) with callable capital commitments
Facility Notional:	USD [10] billion [or alternative MDB base currency]
Lender Subscription Amount:	The amount that each lender commits under the terms of the Facility (in total, the Facility Notional)

Perpetual Bond Issuance Facility description

Facility Start Date:	[]
Facility End Date:	Perpetual, subject to an individual Lender giving [5] years written notice to withdraw from the Facility
Facility Fee:	[0.05%] p.a., ACT/360
Drawdown Dates:	Monthly, from the Facility start date up to and including the Facility End Date
Drawdown:	On each Drawdown Date, the Borrower has the right to issue Perpetual Bonds to the Lenders in proportion to each Lender Subscription Amount, subject to the Minimum Issuance Notional and the Drawdown Constraint
Drawdown Constraint:	The Borrower may only exercise its right to issue under the Facility if the capital adequacy ratio (or equivalent calculated risk-

based metric(s)) is below
[14]%

Drawdown Limits:

The MDB may issue a maximum of USD [5] billion per annum, with the maximum total issuance equal to the Facility Notional

Perpetual Bond terms

Issuer:

Borrower

Minimum Issuance Notional:

USD 1 billion plus an integral multiple of the Denomination

Denomination:

USD 10 million

Issue Date:

Drawdown Date + 3 months

Maturity Date:

Perpetual

Issue Price:

[100%]

Coupon:

USD SOFR + [x%]

Coupon Dates:

Semi-annually, starting 6 months after Issue Date subject to Coupon Cancellation

Coupon Cancellation:

Coupons are cancelled subject to the breach of a risk-based metric [this metric (or metrics) should be regularly calculated and determined by the Issuer. This might include parameters such as: (i) percentage of non-accruing loans; (ii) internal capital adequacy calculation; (iii) equity-to-loans ratio; (iv) credit value-at-risk]

Coupon Payment Dates:

Two (2) business days after each Coupon Date

Day Count Fraction:	ACT/360
Issuer Call:	The Issuer has the right to call the Perpetual Bond on the Issuer Call Dates subject to the Capital Adequacy Condition
Capital Adequacy Condition:	The Issuer Call may only be exercised if the capital adequacy ratio (or equivalent calculated risk-based metric(s)) after the call is above [20]%
Issuer Call Dates:	Ten (10) years from the Issue Date, and annually thereafter
Call Redemption Price:	[100%]

Additional Perpetual Bond terms

[Callable Capital Modification ⁷ :	<p>The Borrower agrees that each Lender's subscribed but unpaid capital ('callable capital') will be reduced by the sum of the outstanding notional of perpetual bonds that are issued under the terms of this Facility.</p> <p>For the avoidance of doubt, if Perpetual Bonds are called, then a corresponding amount of callable capital will be reinstated]</p>
Seniority:	Subordinated to all other debt instruments, senior to any loss-absorbing hybrid capital
Calculation Agent:	[]

⁷ If this clause were to conflict with the MDB's statutes, it could be omitted.

Settlement:	Euroclear
Governing Law:	English
Listing:	None

Disclaimers

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Appendix 2 MDB Proactive Intervention Framework (PIF) - Illustration

PIF Score		Description
1	Low	<p>No risk to the MDB's viability</p> <p>A well-managed institution that exhibits strong performance and has established a risk management framework relative to its size and complexity. Minor weaknesses are identified as part of continual improvement that do not require immediate management action.</p>
2	Lower medium	<p>Moderate risk to the long-term financial viability of MDB.</p> <p>Management has identified vulnerabilities in MDB's financial position and deficiencies in its risk management and/or governance practices, which require remedial action by the board and senior management. The issues may trigger management concerns in the future if adequate recovery measures are not taken within appropriate timeframes. However, given the institution's overall strength and financial capacity, these issues can be addressed without any intervention by management.</p>
3	Upper medium	<p>Risk to viability absent action by the MDB is imminent.</p> <p>Significant threats over the short to medium term to an MDB's 'financial viability' (or another term linked to exhausting paid-in capital) have been identified. The institution exhibits serious financial deficiencies. MDB risks could arise if the issues identified are not satisfactorily addressed and resolved by generating material financial resources organically or from external sources.</p>
4	High	<p>Imminent risks to the financial viability of MDB have materialised or</p>

		<p>are likely to do so in the short term.</p> <p>The position of MDB has deteriorated such that it is assessed there is a real risk the MDB will become non-viable (for example, exhausted, or forecast to exhaust, paid-in capital resources and reserves, but the possibility of corrective action remains). Non-viability of the MDB is probable unless sufficient material recovery actions are implemented imminently.</p>
5	Non-viability	<p>The MDB has been assessed to be no longer viable or is likely to be no longer viable. MDB could be placed into liquidation.</p> <p>This was determined on the basis that it was not possible for the MDB to take any action other than liquidation within a reasonable time to preserve itself. Measures and resources external to the MDB are required to preserve continuity in its lending services and protect the public interest.</p>

Appendix 3 MDB

recovery plans: key elements

MDBs' recovery plans should describe those actions that lead to the rapid and orderly restoration of the MDB in the event of material financial distress for the MDB. The recovery plan should contain the MDB's view and undertaking to the extent that its recovery plan is executable in plausible adverse scenarios. A summary of major impediments to execution with the intent of the MDB to improve the efficacy of its plan should be provided. There should be a description of any material changes, reasons for any such changes and any action taken by the MDB on the plan since the last recovery plan (if any).

Effective recovery planning makes a MDB more resilient to financial stress. A recovery plan should include an MDB's risk management framework for monitoring and recovery options to respond to a range of stress scenarios. These recovery options should help the MDB to return to a stable and sustainable condition. Each aspect of the plan should be underpinned by a detailed analysis and justification.

An MDB recovery plan should contain the following minimum elements, as well as general considerations MDBs should take into account, when developing their recovery plans. It covers:

- **Recovery options:** MDBs should provide a 'menu of recovery options' that enables the MDB to respond to financial stress, whether idiosyncratic or systemic, and to assess the feasibility and impact of each option. This consideration of recovery options before stress occurs is an essential component of an MDB's preparedness and greatly increases the probability that the MDB will be able to recover. MDBs should include in their plans a sufficiently broad range of recovery options to maximise the chance that there will be implementable options in different types of stress. Plans should not be limited to easily implementable recovery options. The choice of recovery options should be suitable for the MDB's business model and be based on realistic assumptions using high-quality analysis. MDBs should detail and explain the expected impact of each recovery option in the

analysis included in the recovery plan. The analysis should be of sufficient quality for MDB boards and shareholders to assess whether the impacts are credible. The financial impact of recovery options should be quantified – as a minimum – in terms of the MDB’s chosen capital target methodology and liquidity position, as well as in terms of the relevant nominal impacts and the impact on the balance sheet and profitability. MDBs should include the timelines on which recovery options could be implemented. MDBs should distinguish between the time needed to execute an option and the time needed to realise its benefits.

- **Recovery capacity:** It is important that MDBs understand the total financial benefits they could credibly realise in a range of stresses if they need to do so (that is, their ‘recovery capacity’). The total recovery capacity should include the benefits of all options that could be realised together under different types of stress.
- **Recovery plan Indicators:** An effective indicator framework maximises the chance that the MDB is alerted to an oncoming stress with sufficient notice to implement – and realise the benefits of – any necessary recovery options. The trigger of an indicator should be used as a prompt to consider the situation and whether it is appropriate to take any actions; for example, it might trigger the convening of a senior decision-making committee. To allow MDB flexibility, the trigger of an indicator should not be used as an automatic trigger for a predefined set of management actions. These triggers could comprise a combination of quantitative and qualitative indicators and tend to relate to the solvency and liquidity of the institution in question under stressed scenarios. MDBs should ensure their recovery plan indicator frameworks are integrated into the MDB’s risk management practices. MDBs should ensure they have a coherent process to monitor indicator metrics within their management information framework. MDBs should set out the governance surrounding the monitoring of indicators and associated escalation procedures in their recovery plan.
- **Scenario testing:** Scenario testing is important to demonstrate that the recovery plan is suitable for use in a range of different types of stress and to test how different elements of the plan (such as indicators, governance and options) would interact in these stresses. The MDB needs to define a set of stress scenarios (idiosyncratic, systemic and a combination of the two) under which the efficiency of the different recovery options can be assessed by reference to their impact on capital, liquidity, profitability and operations. MDBs should use scenarios that are relevant to their business model and are sufficiently severe to test the plan. The range of scenarios included should be adequate to test the plan. The MDB should define and justify its point of near failure and scenarios should be sufficiently severe to take the MDB to this point (that is, a reverse stress test).

- Fire drills: Fire drill exercises are ‘live’ simulation-type exercises where the MDB acts out key parts of a response to a designed scenario. This is a useful way to test the effectiveness of the recovery plan in a ‘live’ situation. The MDB should carry out at least one fire drill exercise in its recovery plan every one to three years. Fire drill exercises should be overseen by the board and involve senior people who would be required to use the relevant parts of the plan and take decisions in an actual stress situation. MDBs should use the findings of these exercises to improve their plans and demonstrate how the arrangements set out would work in practice.
- Governance: Effective governance arrangements are crucial for: (a) the implementation of the recovery plan; and (b) the production, review and sign-off of the recovery plan. MDBs should include in their recovery plans a sufficiently clear description of the escalation and decision-making processes relevant to the recovery plan, as part of the MDB’s wider risk management framework. MDBs should detail who is responsible for taking what decisions and when. This should ensure that effective action is taken in a timely manner and should include procedures to follow during recovery, such as the identification of key people involved and their roles and responsibilities. An MDB’s recovery plan should clearly state at what point the MDB board and shareholders would be informed of the MDB’s situation. The MDB’s overall recovery planning framework should be the responsibility of the chief finance officer (CFO) or similar senior MDB executive.
- Communication plan: MDB recovery plans should include a communication plan to ensure that there is a clear strategy for managing the dissemination of timely and appropriate information to stakeholders (both internal and external) during the MDB’s recovery process. In particular, MDBs should consider how they will manage any negative market reaction to recovery options, mitigate the potential impact of recovery options on the MDB’s financial position, and detail how the approach seeks to minimise the impact on the financial system more widely. There should be a clear implementation plan for communications, tailored to each recovery option. Scenario testing should explain how the communication strategy would mitigate risks associated with the implementation of recovery options.
- The relevance of the recovery plan to the MDB: MDBs should ensure that their recovery plan appropriately reflects their business model, structure, operations and risk strategy. MDBs should identify core business lines and critical business lines or lending operations for the purposes of recovery planning and map these to the MDBs’ organisational structure. MDBs are strongly encouraged to combine any existing liquidity planning and their recovery plan into one integrated document. This would ensure

that the MDB has a coherent process for being alerted to and addressing a liquidity stress and helps to ensure a coherent risk management framework.

Much of the above is based on the approach adopted by the Bank of England Prudential Regulation Authority in its Supervisory Statement Recovery Planning (2022) which applies to banks.

Appendix 4 Case study: 'temporary' callable capital

Canada and South Korea provision of 'temporary' callable capital and G20 leaders' support for MDBs developing other contingent capital instruments

In 2009, Canada made up to US\$4 billion available on a temporary basis to Inter-American Development Bank (IDB). The motive for this action was to offset rising borrowing member demand on the IDB due to the global economic crisis, putting pressure on its internally set policy lending limits. Faced with the prospect of IDB reducing its lending, despite member debt due to insufficient capital, Canada made a temporary capital subscription to the IDB of up to \$4 billion in additional Canadian callable capital. At the time, Canada described this temporary provision of capital as an innovative proposal that would double Canada's callable capital at the IDB. It was clear that the provision of such new capital would not carry voting rights.

Canada also provided temporary callable capital twice to the African Development Bank (AfDB) (in 2010 and 2019) to address pressures from rating agencies as the bank responded to countercyclical demands. Canada waived additional voting rights associated with the capital. When Canada was downgraded and another shareholder placed on negative outlook by Fitch, AfDB had to cut projected lending over the 10-year plan by 23%. In response, another temporary subscription from Germany, Denmark and Sweden was approved by its board until 2023, this time with commensurate changes in voting rights.

In 2009, South Korea also provided US\$306.1 million on a temporary basis to the AfDB to enable the institution to respond to African countries' financial demands. This enabled AfDB to avoid reducing its outstanding loans by increasing its usable capital on a temporary basis.